

Retailers' Occupation Tax is imposed upon persons selling canned computer software at retail. See 35 ILCS 120/2. (This is a GIL).

August 17, 2001

Dear Xxxxx:

This letter is in response to your letter dated April 6, 2001 that we received on April 30, 2001. The nature of your letter and the information you have provided require that we respond with a General Information Letter, which is designed to provide general information, is not a statement of Department policy and is not binding on the Department. See 2 Ill. Adm. Code 1200.120(b) and (c), which can be accessed at the Department's Website at <http://www.revenue.state.il.us/legalinformation/regs/part1200>.

In your letter, you have stated and made inquiry as follows:

The decade of the 1990s was characterized by the erosion of the tax bases of states and localities. Some of this erosion was due to discretionary policy changes, but other factors were also at play, including the emergence of electronic commerce. ORGANIZATION is conducting a study of this phenomenon, emphasizing shifts in the structure of the sales tax base. In order to complete this study, we need your help. Enclosed is a brief survey intended to capture information on the recent tax status of specific items that might be included in your state's sales tax base. In most instances, it should take no longer than 10 minutes to complete this form.

The survey may be returned via first-class mail using the enclosed postage-paid envelope, or you may fax your response. If the information requested on the survey is available in some alternative form, please forward this rather than completing our form. We ask that the form be returned no later than May 11, 2001. Should you have any questions regarding this study, please contact NAME. If you are interested in a copy of our findings, please indicate so on the survey form. We thank you in advance for your help in this important matter.

We are unable to respond in the format you requested. We are, however, providing the following general information in order to respond to your questions in a more complete manner. Subject to the following comments, the items on your list are generally subject to sales tax in Illinois. Please be advised the Department of Revenue does not approve the accuracy of tax information publications.

While the general State Retailers' Occupation Tax (sales tax) rate is 6.25% measured upon gross receipts, sales of food (not prepared for immediate consumption), drugs, medicines and medical appliances are taxed at the rate of 1%. Section 1 of the Retailers' Occupation Tax Act (35

ILCS 120/1) defines “gross receipts” from sales of tangible personal property at retail to mean the total selling price or the amount of such sales. The “selling price” or “amount of sale” means the consideration for a sale valued in money whether received in money or otherwise, and shall be determined without any deduction on account of the cost of the property sold, the cost of materials used, labor or service costs, or any other expense whatsoever. See 86 Ill. Adm. Code 130.410.

There are also various local sales taxes enacted by local units of government including home-rule and mass transit authorities. For the total sales tax rate at a specific location, one can access the Department’s Sales Tax Rate Reference Manual (updated 7/01/01) on its Website under “publications.”

In general, the Retailers' Occupation Tax does not apply to sales of machinery and equipment used primarily in the manufacturing or assembling of tangible personal property for wholesale or retail sale or lease. Please refer to 86 Ill. Adm. Code 130.330 concerning the Manufacturing Machinery and Equipment Exemption.

The manufacturing process is the production of articles of tangible personal property or assembling different articles of tangible personal property by procedures commonly regarded as manufacturing, processing, fabricating, or refining which changes some existing material or materials into a material with a different form, use or name. These changes must result from the process in question and be substantial and significant, Section 130.330(b)(2).

Please note the exemption does not apply to electricity, steam, natural gas, and other fuels, Section 130.330(c)(3). While this exemption applies to sales of tangible personal property that would normally be subject to Retailers' Occupation Tax, a separate tax act imposes tax upon the sale and use of electricity in Illinois. The Electricity Excise Tax Law (35 ILCS 640/1 et seq.) imposes a tax upon the privilege of using in this State electricity purchased for use or consumption and not for resale, other than by municipal corporations owning and operating a local transportation system for public service. The Law contains no exemption for electricity used in manufacturing. See Section 2-4 of the Law (35 ILCS 640/2-4).

The Illinois Retailers' Occupation Tax and Use Tax do not apply to the sale of natural gas or gas services by public utilities or their use by consumers. However, the sale of natural gas or gas services in Illinois is subject to taxation under the Illinois Gas Revenue Tax Act (35 ILCS 615/1 et seq.). Receipts from the sale of newspapers and periodicals are not taxable pursuant to the newsprint and ink exemption.

As a general proposition, Illinois Retailers' Occupation Tax and Use Tax apply to gross receipts from retail sales of transportation equipment, unless one can document an exemption. There is a rolling stock exemption from Illinois Retailers' Occupation Tax and Use Tax and it is described in 86 Ill. Adm. Code 130.340. As this section indicates, the exemption is available to interstate carriers for hire for tangible personal property used as rolling stock moving in interstate commerce.

The exemption applies to sales of tangible personal property to lessors under leases of one year or longer executed or in effect at the time of purchase with interstate carriers for hire for use as rolling stock moving in interstate commerce. A lessor will not incur Use Tax on the purchase of the vehicle that is leased to the interstate carrier for hire for use as rolling stock moving in interstate commerce under a lease term of one year or longer. See 35 ILCS 105/3-55(b) and 120/2-5(12). If a lessor leases a vehicle to an interstate carrier for hire under a lease term of less than one year, the rolling stock exemption is also available because the tax does not apply to the use by (or sale to)

lessors, owners, or shippers of tangible personal property that is utilized by interstate carriers for hire for use as rolling stock moving in interstate commerce. See 35 ILCS 105/3-55(c) and 120/2-5(13).

Effective August 14, 1999, motor vehicles, trailers, and property attached to those motor vehicles and trailers must carry persons or property for hire in interstate commerce on 15 or more occasions within a 12-month period to qualify for the exemption. See 35 ILCS 120/2-51; and 86 Ill. Adm. Code 130.340(e). For other types of property used in interstate commerce, the interstate carriers must be able to show, from their books and records, that the property has moved in interstate commerce for hire on a regular and frequent basis in order to qualify for the exemption. Not all items of tangible personal property used on an interstate carrier for hire qualify for the rolling stock exemption. As explained in subsection (b) of Section 130.340, the exemption does not apply to fuel, jacks, flares, or other items that, although used in servicing the transportation vehicle, do not become a part of such vehicle.

Purchasers also must be recognized by the appropriate federal or state regulatory agency as interstate carriers for hire and have received a Certificate of Authority to engage in interstate commerce. Please note that it is not the type of item that determines whether or not it qualifies as rolling stock, but rather, how a qualifying interstate carrier uses the item. In addition to receiving the proper Certificate of Authority, purchasers should be aware that only those items used specifically as rolling stock would qualify. See 86 Ill. Adm. Code 130.340.

The sale of containers, as that term is defined in 86 Ill. Adm. Code 130.2070, is not subject to Retailers' Occupation Tax when the purchasers of such containers transfer to customers the ownership of the containers together with what is contained in them. That is, sellers of containers to purchasers who sell tangible personal property contained in such containers to others are deemed to make sales of such containers to purchasers for purposes of resale, the receipts from which sales are not subject to the Retailers' Occupation Tax, if the purchasers of such containers transfer the ownership of the containers to their customers together with the ownership of the tangible personal property contained in such containers.

Sellers of containers to purchasers who do not transfer the ownership thereof to others, but who intend such containers merely to provide a means of containing tangible personal property while in the process of being delivered to their customers, retaining and reusing or discarding the containers after such delivery is completed, and sellers of containers to purchasers who use such containers as a means of storing tangible personal property, are making sales for use or consumption, and their receipts from such sales are subject to the Retailers' Occupation Tax. Please refer to 86 Ill. Adm. Code 130.2070.

Regarding agricultural equipment, please be advised that even though sales may be at retail, the Illinois Retailers' Occupation Tax does not apply to farm machinery and equipment, both new and used, including that manufactured on special order, certified by the purchaser to be used primarily in production agriculture or State or federal agricultural programs. Machinery means major mechanical machines or major components thereof contributing to the production agriculture process or used primarily in State or Federal agricultural programs. New or used repair or replacement parts, necessary for the operation of the machine used in production agriculture or in State or Federal agricultural programs, qualify for the exemption.

No item qualifies for the farm machinery exemption in and of itself. It must be used primarily in production agriculture as explained in 86 Ill. Adm. Code 130.305. No transaction is exempt unless the seller obtains a certification that contains the information required by Section 130.305(m).

Machinery or equipment that is used both in qualifying and non-qualifying activities must be used primarily in a qualifying activity in order for the exemption to apply.

Please see 86 Ill. Adm. Code 130.1955, the regulation that explains the exemption afforded farm chemicals. In general, farm chemicals include chemical products used in production agriculture, the products of which are to be sold, or in the production or care of animals that are to be sold or the products of which are to be sold. Chemicals, such as insecticides, can qualify for the exemption if they are applied to soil used to grow crops, or to the crop plants themselves that will be sold, or directly to livestock that will be sold or the products of which will be sold. Chemicals such as disinfectants used for general farm maintenance do not qualify for the farm chemical exemption.

The purchase of livestock or seed is not taxable under the resale exemption if the producer intends to resell the livestock or products therefrom, or the crop produced from the seed. Fertilizer used to produce crops for sale is also exempt, as is feed that is fed to livestock that will be sold. However, these items are taxable if purchased or produced for use. For example, hogs, chickens, eggs or sweet corn produced by a farmer for his family's own consumption are taxable when the seed or young animals are purchased. Please refer to 86 Ill. Adm. Code 130.2100 and 130.2110.

Although retail sales of cigarettes, gasoline and liquor are subject to Retailers' Occupation Tax liability, these items are also taxed under the Cigarette Tax Act, the Motor Fuel Tax Law and the Alcoholic Liquor Act respectively.

Regarding rental of tangible personal property, please be advised that under Illinois law, "true leases" and "leases" that are actually conditional sales contracts are treated differently for Retailers' Occupation and Use Tax purposes. Lessors are subjected to a Use Tax on their cost price of tangible personal property that they acquire to use by leasing under true leases in Illinois. This means lessors in Illinois encounter a front-end tax on value rather than an amortized tax on receipts. The only exception is automobiles rented for one year or less, which are subject to the Automobile Renting and Use Tax found at 35 ILCS 155/1 et seq.

A true lease generally has no buy out provision at the close of the lease. If a buy out provision does exist, it must be a fair market value buy out option in order to maintain the character of the true lease. The lessor of tangible personal property under a true lease in Illinois is deemed the end user of the property to be leased. See 86 Ill. Admin. Code 130.220. As the end user of tangible personal property located in Illinois, the lessor owes Use Tax on his cost price of such property. Normally, this tax is paid to an Illinois registered retailer at the time of purchase. If not, the lessor must self-assess and remit this tax to the Department. The State of Illinois imposes no tax on rental receipts, other than short-term leases of automobiles, as noted above.

In Illinois, the Hotel Operators' Occupation Tax Act imposes a tax upon persons engaged in the business of renting, leasing or letting rooms in a hotel. The Hotel Operators' Occupation Tax Act does not include any provision for rentals to exclusively religious, charitable, or educational organizations, or for governments or their agencies.

The only exemptions available to hotel operators are for rentals to permanent residents and to certain diplomatic personnel. The exemption for rentals to certain diplomatic personnel applies only to diplomatic personnel possessing certain types of diplomatic tax exemption cards, issued by the U.S. Department of State, Office of Foreign Missions.

On the second sheet of your chart the first category of items is entitled *Services Rendered with Sale*. Please be informed the items you have numbered 31 through 34, and 38, subject to the following exceptions, are services subject to liability under the Service Occupation Tax Act.

The exceptions involve transactions when tangible personal property is transferred to customers for use or consumption separate and apart from the rendering of service. These are retail sales subject to Retailers' Occupation Tax liability. For example, when a barber or beauty shop operator sells combs, hair spray or other merchandise to customers for use or consumption separate from their rendering of service, they incur Retailers' Occupation Tax on such sales. An undertaker or Funeral Director is engaged in the business of selling tangible personal property at retail subject to Retailers' Occupation Tax when he sells items such as caskets, flowers, grave clothing and pallbearer's gloves. This is true even if such sales are made as part of a funeral and do not have their selling prices separately stated on an invoice. See 86 Ill. Adm. Code 130.2130 for presumptions used in determining the retail price of these items when their selling prices are not stated on the funeral bill.

When tangible personal property is transferred incident to sales of service, such transactions are subject to liability under the Service Occupation Tax Act. The appropriate method for calculating tax liabilities can be determined based upon the following information.

Under the Service Occupation Tax Act, servicemen are taxed on tangible personal property transferred as an incident of their sales of service. Servicemen incur either Service Occupation Tax (SOT) liability or Use Tax liability in these transactions. The tax consequences depend upon the method used to calculate the liability. Servicemen may calculate their tax base in one of four ways: 1. separately stated selling price; 2. 50% of serviceman's entire bill; 3. SOT on his cost price if he is a registered de minimis serviceman; or, 4. Use Tax on his cost price if he is a de minimis serviceman not required to be registered under Section 2a of the Retailers' Occupation Tax Act. Please see 86 Ill. Adm. Code 140.101, the Basis and Rate of the Service Occupation Tax.

Using the first method, servicemen may separately state the selling price of each item transferred as a result of the sale of service. The tax is then calculated on the separately stated selling price of the tangible personal property transferred. If the servicemen do not separately state the selling price of the tangible personal property transferred, they must use 50% of the entire bill to the service customer as the tax base. Both of the above methods provide that in no event may the tax base be less than the servicemen's cost price of the tangible personal property transferred. Please refer to 86 Ill. Adm. Code 140.106.

The third way servicemen may account for their tax liability only applies to de minimis servicemen who have either chosen to be registered or are required to be registered because they incur Retailers' Occupation Tax liability with respect to a portion of their business. See 86 Ill. Adm. Code 140.109. Servicemen may qualify as de minimis if they determine that the annual aggregate cost price of tangible personal property transferred as an incident of the sale of service is less than 35% of the total annual gross receipts from service transactions (75% in the case of pharmacists and persons engaged in graphics arts production). Registered de minimis servicemen are authorized to pay Service Occupation Tax (which includes local taxes) based upon their cost price of tangible personal property transferred incident to the sale of service. Such servicemen should give suppliers resale certificates and remit Service Occupation Tax using the Service Occupation Tax rates for their locations. Such servicemen collect a corresponding amount of Service Use Tax from their customers.

The final method of determining tax liability may be used by de minimis servicemen that are not otherwise required to be registered under Section 2a of the Retailers' Occupation Tax Act. Such de minimis servicemen handle their tax liability by paying Use Tax to their suppliers. If their suppliers are not registered to collect and remit tax, the servicemen must register, self-assess and remit Use Tax to the Department. The servicemen are considered to be the end-users of the tangible personal property transferred incident to service. Consequently, they are not authorized to collect a "tax" from the service customers. See 86 Ill. Adm. Code 140.108.

Illinois law imposes Retailers' Occupation Tax upon persons who sell computer software at retail. The regulation that governs sales of computer software distinguishes between taxable canned software and exempt custom software, and also covers how certain software licenses may not be taxable. See 86 Ill. Adm. Code 130.1935.

The sale of canned software to Illinois users is considered to be the taxable sale of tangible personal property regardless of the form in which it is transferred or transmitted, including tape, disc, card, electronic means or other media. See 86 Ill. Adm. Code 130.1935(a). Tax applies to the entire charge made to the customer, including charges for all associated documentation and materials. Charges for updates of canned software are considered to be sales of software. Charges for training, telephone assistance, installation and consultation are exempt if they are separately stated from the selling price of canned software. Please refer to 86 Ill. Adm. Code 130.1935(b).

Generally speaking, a computer program prepared to the special order of a customer to meet the customer's special needs is custom software, Section 130.1935(c). This usually involves preparation of the program for the customer's use by analysis of the customer's requirements by the vendor and adaptation of the program by the vendor so it can be used in the customer's specific work environment. This may occur when a software database is created based upon the specific requirements of a particular customer. However, if a database is created and marketed to the general public it would be taxable software, assuming no other exemption applies.

Please be advised persons who take tangible personal property and permanently affix it to real estate act as construction contractors. See 86 Ill. Adm. Code 130.1940 and 130.2075. Construction contractors incur Use Tax and local Retailers' Occupation Tax reimbursement liabilities, payable to their suppliers, based upon their cost price of items which they purchase for subsequent incorporation into real estate.

Where contractors perform repair work on permanently affixed items, the Department considers these to be construction contract situations and contractors incur Use Tax and local Retailers' Occupation Tax reimbursement liabilities on the cost price of supplies and repair parts permanently affixed to realty.

As noted above, Illinois, construction contractors are deemed to be end users of building materials, including manufactured housing units or pre-fabricated buildings, that they permanently affix to real estate. Contractors incur a Use Tax liability on their cost price of the materials permanently affixed to real estate. Illinois retailers making such sales also incur Retailers' Occupation Tax on the gross receipts from the sales of these building materials to the contractor. Thus, contractors having contracts with customers to sell and permanently affix manufactured homes incur a Use Tax liability on their cost price of materials permanently affixed to real estate. If they do not remit this tax to Illinois registered suppliers, the contractors must register, self-assess and remit the Use Tax to the Department.

In contrast, if Illinois sellers of manufactured homes do not have contracts with the purchasers to permanently affix the homes to real estate, they do not act as construction contractors and do not incur a Use Tax liability. Rather, they act as retailers in retail transactions and incur a Retailers' Occupation Tax liability and must collect the corresponding Use Tax from their purchasers unless an exemption applies (e.g., a sale for resale would occur if the purchaser buys the home for resale to a contractor).

Your final category is entitled *Other Service*. The items you list thereunder are generally subject to liability under the Service Occupation Tax Act, as described above.

I hope this information is helpful. The Department of Revenue maintains a Web site, which can be accessed at www.revenue.state.il.us. If you have further questions related to the Illinois sales tax laws, please contact the Department's Taxpayer Information Division at (217) 782-3336.

If you are not under audit and you wish to obtain a binding Private Letter Ruling regarding your factual situation, please submit all of the information set out in items 1 through 8 of Section 1200.110(b).

Very truly yours,

Karl W. Betz
Associate Counsel

KWB:msk
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